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**EXAMPLE A**

Assumptions		Computer Usage	Hardware	Your Personal Net Worth Software
Cost of Computer	\$ 2,500	Business	45%	0%
Cost of Software	\$ 100	Production of Income	25%	50%
Tax Bracket	35%	Personal	30%	50%

Year	Hardware Deduction	Software Deduction	Computer ITC	Software ITC	Total Tax Savings @ 35%
1	\$ 73 (1)	\$ 10	None	None	\$ 29
2	146	10			55
3	146	10			55
4	146	10			55
5	146	10			55
6-13	1,093	---			381
Total	\$ 1,750	\$ 50			\$ 630

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**EXAMPLE B**

Assumptions		Computer Usage	Hardware	Your Personal Net Worth Software
Cost of Computer	\$ 2,500	Business	75%	75%
Cost of Software	\$ 100	Production of Income	5%	5%
Tax Bracket	35%	Personal	20%	20%

Year	Hardware Deduction	Software Deduction	Computer ITC	Software ITC	Total Tax Savings @ 35%
1	\$ 300 (1)	\$ 16	\$ 160	None	\$ 271
2	440	16			160
3	420	16			153
4	420	16			153
5	420	16			153
Total	\$ 2,000	\$ 80	\$ 160		\$ 890

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**Note:** The above examples assume that software is **not** eligible for ACRS or ITC. In addition, an 8% investment tax credit rate was assumed and no first year expense election was made.

(1) Under ACRS, a half year depreciation convention is in effect for the first year of use for tangible personal property.

Dear Your Personal Net Worth Purchaser:

The Internal Revenue Code as amended by the Tax Reform Act of 1984 allows income tax deductions and credits for certain uses of personal computers and computer software. The amount and timing of deductions and credits allowed depends on the percentage of "qualified business use" of the asset, as well as the percentage of "use in the production of income." There are no deductions or credits allowed for personal use.

**Qualified business use** generally means any use in a trade or business of the taxpayer. Use by an employee in connection with his/her employment is treated as use in a trade or business if the property is required for the convenience of the employer and as a condition of employment. In addition, qualified business use includes use in a trade or business by a self-employed individual.

**Use in the production of income** includes the management of investments as well as tax planning and recordkeeping.

### **Personal Computers (Hardware)**

Where "qualified business use" of the computer exceeds 50%, that portion of the cost which relates to both the qualified business use and the use in the production of income is eligible for ACRS depreciation (on an accelerated basis over 5 years), investment tax credit and a special election to expense up to \$5,000 of the cost of the equipment in the year it is placed in service. If qualified business use later falls below 50%, some of these tax benefits may have to be recaptured.

Where qualified business use is less than 50%, those costs relating to qualified business use and use in the production of income may be deducted on a straight-line basis over 12 years. Such costs would not be eligible for investment tax credit or the first year expensing election.

### **Computer Software**

A depreciation deduction can be taken for that portion of the cost of computer software which relates to qualified business use or use in the production of income. The Internal Revenue Service has ruled that where computer software is purchased in conjunction with computer hardware and the costs are not separately stated, accelerated depreciation (ACRS) and the investment tax credit may be available.

Where computer software is separately purchased, a conservative approach would be to deduct the qualified business use and use in the production of income portion of the cost of the software on a straight-line basis over its useful life. The useful life of an asset is the period over which the asset may be reasonably expected to be useful to a taxpayer in a trade or business or in the production of income. Although the useful life of an asset is a facts and circumstances question, a useful life of 5 years for computer software would appear to be reasonable. Under this approach, the software costs would **not** be eligible for accelerated depreciation (ACRS), the investment tax credit or the first year expense election. A more aggressive approach may be justified in light of some analogous court decisions (although to date, no court has dealt directly with the issue of computer software). Some courts have ruled that property which is similar to computer software (i.e., master tapes, negatives and films) was eligible for the investment tax credit and accelerated depreciation deductions. It is the Internal Revenue Service's current position, however, that computer software is not eligible for ACRS depreciation and the investment tax credit. You should consult your tax advisor before taking this more aggressive position.

*Touche Ross*